Supreme Court, U.S.
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NO. 90-1389

IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

CLARK EQUIPMENT COMPANY, and consolidated subsidiaries,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

REPLY TO BRIEF IN OPPOSITION

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18p.

CORPORATE DISCLOSURE

Clark Equipment Company makes the following disclosure:

1. Clark Equipment Company has no parent corporation.

2. Other than wholly owned subsidiaries, Clark Equipment Company has the following subsidiaries.

Subsidiary	*Percentage Controlled*
Hurth Axle S.p.A.	83%
Hurth Axle France S.A.R.L.	83%
Hurth Axle Valsugana S.p.A.	84%
Hurth Axle North America, Inc.	86%

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CLARK EQUIPMENT COMPANY, and consolidated subsidiaries,
Petitioner,

v.

UNITED STATES OF AMERICA,
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REPLY TO BRIEF IN OPPOSITION

STATEMENT

Petitioner and respondent agree as to the facts under review. Petitioner and respondent also now agree the proper interpretation of Section 249 of the Internal Revenue Code is to deny deduction of amounts which do not represent costs of borrowing. Petitioner and respondent also agree *National Can Corp. v. United States*, 687 F.2d 1107 (7th Cir. 1982) and *Chock Full O'Nuts Corp. v. United States*, 453 F.2d 300 (2nd Cir. 1971) were properly decided by the Seventh and Second Circuits based on complementary Internal Revenue Code provisions denying tax deduction for amounts which do not represent costs of borrowing.

Respondent maintains, however, that petitioner's costs are not costs of borrowing because they were realized when debentures were converted. Respondent also maintains that petitioner failed to prove to the Commissioner of Internal Revenue that petitioner's costs were costs of borrowing.

Respondent in denying petitioner's costs were costs of borrowing does not say why tax deduction should be disallowed, other than to say the costs arose from the conversion of petitioner's debentures. Respondent thus invites this Court to adopt and sanction the error of the Sixth Circuit that costs of borrowing realized when debentures are converted are not tax deductible costs. Respondent urges this by its invitation to this Court to

misapply the law of the Seventh and Second Circuits in *National Can Corp.* and *Chock Full O'Nuts, supra.*

Petitioner has pointed out the denial of tax deduction in *National Can Corp.* and *Chock Full O'Nuts* was based on the issuance of taxpayer equity in capital transactions rather than attempts to deduct the costs of borrowing. In *National Can Corp.* and *Chock Full O'Nuts* the taxpayers attempted to deduct costs associated with the issuance of their equity. Petitioner has pointed out the references in *National Can Corp.* and *Chock Full O'Nuts* to "costs of conversion" are references to cost of issuing equity by means of a conversion, not, as urged by respondent and found by the Sixth Circuit, a new principal of tax law disallowing costs of borrowing arising when a conversion takes place.

Respondent has now cited additional cases by the Court of Claims, the Tax Court and the Ninth Circuit, where tax deduction is denied to taxpayers involved with convertible debentures. It is appropriate this Court be made aware in *AMF Inc. v. United States,* 476 F.2d 1351 (Ct.Cl. 1973), cert denied, 417 U.S. 930 (1974), cited by respondent, the taxpayer was again attempting to amortize costs associated with the issuance of its own equity, not costs of borrowing. It is also appropriate this Court be made aware in *Hunt Foods & Industries,Inc. v. Commissioner,* 57 T.C. 633 (1972), aff'd, 496 F.2d 532 (9th Cir. 1974) cited by respondent, the taxpayer was attempting to amortize premium associated with the future issuance of its own equity, not costs of borrowing.

It is most appropriate, however, this Court be made aware in *Honeywell, Inc. v. Commissioner,* 87 T.C. 624 (1986), also cited by respondent, that a subsidiary was attempting to amortize hypothetical discount associated with the issuance of the equity of a parent corporation. While the Tax Court in *Honeywell* properly disallowed the amortization of hypothetical discount, it came to its decision by noting both that no discount had occurred, and that the subsidiary had realized no borrowing costs at conversion because the subsidiary acquired the bonds at face value.

Thus, *Honeywell,* cited by respondent, infers that if, as here, the subsidiary had acquired the bonds at a premium the costs would have been tax deductible.

Honeywell, by dicta, thus supports the position of petitioner as to the deduction of actual realized borrowing costs associated with convertible debentures convertible by a subsidiary into the shares of a parent corporation.

Respondent in its invitation to this Court to adopt and sanction the error of the Sixth Circuit that costs of borrowing arising from conversions are precluded from tax deduction, cites Internal Revenue Code Section 171 in its Brief in Opposition as authority for disallowing costs associated with convertible instruments. Internal Revenue Code Section 171 is directed toward amortization of premium paid at the time of issuing a bond. Premium associated with a conversion feature is disallowed by Section 171 because any premium attributable to a conversion feature is speculative until the conversion is exercised or lapses. Section 171 was enacted to disallow speculative prospective tax deductions, as the Tax Court did in *Honeywell.* To suggest Internal Revenue Code Section 171 is authority to disallow costs of borrowing when those costs have been incurred, as has happened here, serves only to emphasize the mischief which the principals enunciated by the Sixth Circuit, if not stricken as inappropriate to the intention of Congress, may engender. If the decision of the Sixth Circuit is not overruled, it will cause the disallowance of tax deductions for other borrowing costs.

While the respondent now argues in its Brief in Opposition that petitioner has failed to demonstrate to the satisfaction of the Secretary under Internal Revenue Code Section 249 that petitioner's losses were attributable to its costs of borrowing, there should be no formal requirement to demonstrate the obvious. That petitioner's losses arose from petitioner's borrowing is clear by the agreed fact pattern which has been uncontested at every level of administrative and judicial appeal. Delivery of $1,839,989 of property to retire $1,447,000 of debt can indicate nothing other than $392,989 of interest expense. Respondent has also issued a private letter ruling to petitioner holding that interest paid by CLEO on each debenture issued by CLEO will be interest paid on a bonafide indebtedness of CLEO so long as such debenture is held by a person other than Clark or one of its affiliates (App. 1). The uncontested fact pattern indicates these conversions were made by parties other than members of the Clark Group. The Commissioner of Internal Revenue has, therefore, ruled that CLEO's interest costs were costs of borrowing and any such requirement of Section 249 has been satisfied. Besides, if as petitioner has consistently argued and as respondent now for the first time concedes, Section 249 was not intended to apply to costs of borrowing, there should be no need to demonstrate such an obvious point as concerns a code section which both parties agree should not apply.

Finally, in its final footnote, respondent argues if Clark had continued to effect the conversions for CLEO by delivering its equity in exchange for CLEO's debentures, that Clark would not have been entitled to a tax deduction for the borrowing costs Clark would not have then incurred. Respondent reasons further that because Clark could have issued equity to retire CLEO's bonds that CLEO be found a sham and be denied a tax deduction for the costs of borrowing which CLEO incurred. The record will show, however, that CLEO properly operated under a private letter ruling issued by respondent holding that CLEO would not be found a sham under this uncontested fact pattern (App. 1). Neither is CLEO obligated to proceed in the most tax costly manner. CLEO made its own converstions and thereby incurred its own borrowing costs. CLEO is thus entitled to a tax deduction for the borrowing costs it has incurred.

For the reasons explained, the Sixth Circuit should be overruled. The Federal tax law concerning borrowing costs needs to be consistently interpreted in every Circuit. The respondent argues (Res. 8) that there is no conflict within the Circuits "which would warrant further review." Petitioner submits the tax law in all other Circuits permits the deduction of borrowing costs arising at the time of delivery of property in a conversion transaction. As is also illustrated by respondent's analogy to the rules for amortizing bond premium, there is danger to the fabric of the tax law in permitting this error by the Sixth Circuit to continue.

CONCLUSION

This petition for a writ of certiorari should be granted.

Respectfully Submitted,

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Clark Equipment Company
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South Bend, Indiana 46601
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Dated: May 14, 1991

APPENDIX

Date: Feb. 11, 1966

T:I:C:1:1

Clark Equipment Company
Buchanan, Michigan 49107

Attention: Mr. R. F. Sumerwell, Tax Manager

In re: Clark Equipment Overseas Finance Corporation

Gentlemen:

This is in reply to a letter from White & Case requesting rulings on your behalf with respect to the creation of Clark Equipment Overseas Finance Corporation and the proposed public offering outside of the United State of $15,000,000 of Guaranteed Debentures due 1981 to be issued by such corporation pursuant to the transactions described below.

The information submitted and the statements made therewith indicate that Clark Equipment Company ("Clark") is a Michigan corporation which, together with its domestic and foreign subsidiaries and associate companies, is engaged in the manufacture and sale of industrial trucks, construction machinery, automotive parts and components, commercial highway trailers, and commercial refrigeration equipment. Clark also has licensing arrangements with certain foreign manufacturers providing for the manufacture of some of such products and it has equity investments in some of such licensees.

Clark anticipates that it will need substantial funds for the expansion of its foreign subsidiaries and associate companies and for other investments in foreign companies. Although it would be possible for Clark to obtain such funds in the United States, in order to cooperate with the United States Government's efforts to improve the balance-of payments position, Clark proposes to obtain the required funds by borrowing from non-United States sources.Pursuant to the above-described proposal, Clark will organize Clark Equipment Overseas Finance Corporation("Overseas"), a new wholly-owned Delaware subsidiary. Clark will make an initial contribution, as capital, of cash and

other property. Such initial contribution will have an aggregate fair market value of not less than $3,000,000. In return for such contribution, Clark, will receive all of the issued and outstanding capital stock of Overseas.

Overseas, through a group of underwriters which may include one or more United States persons, will make a public offering outside of the United States of approximately $15,000,000 of its Guaranteed Debentures due 1981 (the "Debentures"). The Debentures will be convertible and in denominations of $1,000 each. The Debentures will be convertible on and after July 31, 1967, into the common stock of Clark; the conversion price will be in excess of 15 percent of the market price of the common stock of Clark at the time of the public offering of the Debentures. Payments of the principal and of premium, if any, and interest, on, and payments of the sinking fund payments for, the Debentures, will be guaranteed by Clark, so that in the event that Overseas fails to punctually make any such payment, Clark will cause any such payment to be made.

Overseas expects to invest the net proceeds from the sale of the Debentures in foreign corporations by acquiring stock or debt obligations of such corporations; the foreign corporations may include other than existing foreign subsidiaries or associate companies of Clark. Pending the full and final above-described investments, and from time to time as changes in Overseas' investments occur, all or a portion of such funds may be temporarily invested in foreign governmental or corporate securities having periods remaining to maturity of less than one year, and/or all or a portion of such funds may be placed as demand deposits, or time deposits for periods of less than one year, with one or more foreign banks. For the above-set forth reasons, Clark has stated that with respect to the issuance of the stock and the Debentures, Overseas has been formed and will be availed of for the principal purpose of obtaining funds for foreign issuers and obligors.

Overseas will derive most of its income from the dividends and interest paid on stock and debt obligations of foreign issuers and obligors; therefore, it is anticipated that at all times Overseas will derive more than 80 percent of its gross income from sources without the United States. It is also presently anticipated that the investments made by Overseas, together with the assests contributed as capital by Clark, will, during the stated term of the

Debentures, produce income sufficient to meet the interest payments on the Debentures.

Interest Equalization Tax

Section 4911 of the Internal Revenue Code of 1954 imposes the interest equalization tax on cash acquisition by a United States person of stock of a foreign issuer, or a debt obligation of a foreign obligor, if such obligation has a period remaining to maturity of one year or more.

Section 4912(b)(3) of the Code, as relevant to the proposed transaction, provides that the acquisition of the stock or a Debenture of Overseas, which company, with respect to the issuance of the stock and the Debentures, will be formed and availed of for the principal purpose of obtaining funds for a foreign issuer or obligor, shall be deemed an acquisition (from such foreign issuer or obligor) of stock or a debt obligationof such foreign issuer or obligor.

The House of Representatives Report No. 1046, 88th Congress, 1st Session, at Page 29, states that the effect of Section 4912(b)(3) is to treat the stock or debt obligation of such a corporation as that of a foreign issuer or obligor and, therefore, subject to the interest equalization tax unless it is otherwise excluded (as, for example, under sections 4915, 4916, or 4917 or (4918) because of the status of (or relationship of the acquiring person to) the foreign issuer or obligor (or because of prior American ownership); the statues of (or relationship to) the domestic corporation (including its status as a prior American owner) will not serve to provide (or prevent) such an exclusion. (Bracketed material supplied.) Such statement evidences Congress's intention that for purposes of the interest equalization tax, any active role played by the domestic corporation is to be disregarded; the domestic corporation is to be treated as a conduit.

Accordingly, it is held that the stock and the Debentures issued by Overseas for the principal purpose of obtaining funds for a foreign issuer or obligor will be deemed to be stock of such foreign issuer and Debentures of such foreign obligor. Therefore, it is also held that an acquisition of the stock or the Debentures of Overseas by a United States person from Overseas or from other persons will be subject to the interest equalization tax unless one or more specific statutory exemptions (based on the

status of the deemed foreign issuer or obligor or the relationship of the acquiring person to such foreign entity or because of prior American ownership) is found to be applicable. However, pursuant to considering Overseas as a conduit, whenever Overseas is the transferor, the acquisition will be deemed to have been made from the foreign issuers or obligors. Therefore, a United States person acquring such stock or Debentures directly from Overseas would not have available exemption relating to prior American ownership which is provided by Section 4918; however, a United States person acquiring such stock or Debentures from another United States person in the manner described in section 4918 (relating to prior American ownership) would not be subject to the interest equalization tax.

So that a potential acquiring United States person may be given notice of the consequences of the application of section 4912(b)(3) to the proposed transaction, the following legend is to be prominently displayed on each stock certificate issued by Overseas and each of the Debentures issued by Overseas, whether newly issued or issued upon presentment for reregistration or issued in connection with a change in the capital structure affecting such securities:

UNITED STATES INTEREST EQUALIZATION TAX

"The issuer of this (stock)(Debenture) has been formed and availed of for the principal purpose of obtaining funds for foreign issuers or obligors. Consequently, the United States Internal Revenue Service has ruled that United States persons (as that term is defined in Section 4920(a)(4) of the U.S. Internal Revenue Code of 1954) will be required to report and pay United States interest equalization tax with respect to acquisitions of (shares of stock which this certificate represents) (this Debenture) except where a specific statutory exemption is available."

It is also held that any acquisition of the common stock of Clark into which the Debentures are convertible, whether acquired upon conversion or acquired from any other person, will not be subject to the interest equalization tax.

Section 4915(a) of the Code provides, in relevant part, that the interest equalization tax imposed by section 4911 shall not apply to the acquisition by a United States person of stock or debt obligations of a foreign corporation if immediately after the acquisition such person (or one or more includible corporations in an affiliated group as defined in section 1504, of which such person is a member) owns directly or indirectly ten percent or more of the total combined voting power of all classes of stock of such foreign corporation.

Section 1504(a) of the Code provides that the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if:

> (1) Stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and
>
> (2) The common parent corporation owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations.

Accordingly, for purposes of section 4915(a), it is held that Clark and Overseas will constitute an affiliated group, of which both Clark and Overseas will be members.

Section 4915(c)(1) of the Code provides that 4915(a) shall be inapplicable in any case where the foreign corporation is formed or availed of by the United States person for the principal purpose of acquiring, through such foreign corporation, an interest in stock or debt obligations of one or more *other* foreign issuers or obligors, the direct acquisition of which by the United States person would be subject to the interesst equalization tax imposed by section 4911.

Section 4915(d) provides that section 4915(a) shall be inapplicable in any case where the acquisition of stock or debt obligations of the foreign corporation is made with an intent to sell, or to offer to sell any part of the stock or debt obligations acquired to other United States persons.

Accordingly, based upon the information and statements submitted, and based upon the foregoing section of the Code:

1. It is held that the acquisition by Clark of the stock of Overseas, or the acquisition of the Debentures upon conversion, which acquistions pursuant to section 4912(b)(3) will be deemed to be acquistions of the stock of a foreign issuer and the debt obligations of a foreign obligor, will not be subject to the interest equalization tax to the extent that Overseas' investments, including the interim investments, if made directly by Clark, would not subject Clark to the interest equalization tax imposed by section 4911.

2. It is held that if Overseas, directly or by way of a contribution to capital by Clark, acquires the stock or debt obligations of a foreign issuer or obligor with respect to which Clark or Overseas or one or more includible corporations in an affiliated group of which Overseas is also a member, immediately after such acquisitions by Overseas, owns at least ten percent of the total combined voting power of all classes of stock of such foreign issuer or obligor, and the negative requirements set forth in section 4915(c) and (d) are satisfied, such acquisitions by Overseas will not be subject to the interest equalization tax by virture of section 4915(a) of the Code.

Section 4915(c)(3) of the Code provides that in any case where the exemption provided by section 4915(a) has been applied with respect to the acquisition of stock or debt obligations by a United States person, but the foreign corporation is availed of by such person, after the exempt acquisition was made but before the termination of the interest equalization tax, for the principal purpose described in section 4915(c)(1), then liability for the interest equalization tax shall be incurred by such person, in the manner set forth in section 4915(c)(3).

Section 4920(a)(7)(B)(iv) of the Code provides that the period remaining to maturity of any debt obligation which is payable on demand (including any bank deposit payable on demand) shall be considered to be less than one year. Accordingly, it is held that if Overseas places a demand deposit or a time deposit for a period of less than one year with a foreign bank, such deposit will not be subject to the interest equalization tax imposed by section 4911 of the Code. Pursuant to section 4911 of the Code, it is held that the acquisition by Overseas of a foreign governmental or corporate security with a period remaining to maturity of less than one year will not be subject to the interest equalization tax.

It is also held that for purposes of section 4919 (relating to a credit or a refund for underwriters and dealers making sales to non-United States persons), because section 4912(b)(3) is held to be applicable, the Debentures issued by Overseas will be deemed to be debt obligations of the foreign obligors. Furthermore, the foreign issuers and obligors will be deemed to be the offerers with respect to the public offering of the Debentures of Overseas. Therefore, a United States person, acting as a dealer or underwriter, may avail himself of the credit or refund provided by section 4919, if the applicable requirements of such section and the temporary regulations thereunder are satisfied.

Income Tax

Based upon the information and statements submitted, it is held that interest paid by Overseas on each Debenture issued by Overseas will be interest paid on a bonafide indebtedness of Overseas so long as such Debenture is held by a person other than Clark or one of its affiliates; and such interest paid or accrued on the Debentures will be deductible for Federal income tax purposes under section 163(a) of the Code. No opinion is expressed with respect to the validity of indebtedness or the deductibility of interest paid or accrued theron *after* such Debenture is acquired by Clark or one of its affiliates, or *after* the time that Clark or one of its affiliates makes any payment of principal or interest on such Debenture pursuant to Clark's guaranty to make payments of principal and interest in the event that Overseas fails to make such payments.

Section 1441(a) of the Code provides, in relevant part, that all persons, in whatever capacity acting, having the control, re-

ceipt,custody, disposal, or payment of any of the items of income specified in section 1441(b) (which section includes interest) to the extent that any of such items constitutes gross income from sources within the United States, of any nonresident alien individual, or of any partnership not engaged in trade or business within the United States and composed in whole or in part of nonresident aliens, shall deduct and withhold from such items a tax equal to 50 percent thereof.

Section 1.1441-5(d) of the Income Tax Regulations provides that with respect to the definition of nonresident alien individuals, see sections 871 and 7701 of the Code and regulations thereunder.

Section 1.871-2(a) of the Regulations provides, in relevant part, that the term "nonresident alien individual" includes a nonresident alien fiduciary.

Section 1442 of the Code provides, in relevant part, that in the case of foreign corporations, subject to income taxation under the Code; not engaged in trade or business within the United States, there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in section 1441 a tax equal to 30 percent thereof. Items of gross income of foreign corporations engaged in trade or business within the United States are not subject to any witholding requirements.

Section 1.1441-1 of the Regulations sets forth the requirements and manner for proper withholding under sections 1441 and 1442 of the Code. Section 1.1441-3(a) of the Regulations provides that to the extent that items of income constitute gross income from sources without the United States, they are not subject to withholding under section 1.1441-1.

Section 862(a)(1) of the Code provides, in relevant part, that interest other than that derived from sources within the United States as provided in section 861(a)(1) shall be treated as income from sources without the United States.

Section 861(a)(1)(B) of the Code provides, in relevant part, that interest on obligations of resident corporations shall be treated as income from sources within the United States unless it is shown to the satisfaction of the Secretary or his delegate that less than 20 percent of the gross income of such resident payor or domestic corporation has been derived from sources within

the United States, as determined under the provisions of sections 861, 862, 863, and 864, for the 3-year period ending with the close of the taxable year of such payor preceding the payment of such interest, or for such part of such period as may be applicable.

Section 1.861-2(a)(2) of the Regulations provides, that to treat interest paid by a domestic corporation as from sources without the United States, it shall be shown to the satisfaction of the district director of Internal Revenue in whose district the corporation files its return that less than 20 percent of the gross income of such resident payor or domestic corporation has been derived from sources within the United States for the 3-year period ending with the close of the taxable year of the payor which precedes the payment of such interest, or for such part of that period as may be applicable.

Accordingly, based upon the information and the statements submitted, and based upon our conclusion that the Debentures are the bona fide indebtedness of Overseas, it is held that for any year in which it has been shown to the satisfaction of the appropriate district director that for the 3-year period ending with the close of the taxable year of Overseas which precedes the payment of interest on the Debentures, or for such part of that period as may be applicable, that less than 20 percent of the gross income of Overseas has been derived from sources within the United States, the interest paid by Overseas on the Debentures to nonresident alien individuals, to nonresident alien fiduciaries, to any partnership not engaged in trade or business within the United States and composed in whole or in part of nonresident aliens, and to foreign corporations, will not be subject to withholding of any tax. For purposes of determining the source of Overseas' gross income, the rules prescribed by sections 861, 862, 863, and 864 of the Code will govern.

Very truly yours,

Chief, Corporation Tax Branch